INTEREST RATES, WAGES, EMPLOYMENT, AND INFLATION

HEARING

BEFORE THE

COMMITTEE ON THE BUDGET
HOUSE OF REPRESENTATIVES

ONE HUNDRED THIRD CONGRESS

SECOND SESSION

JUNE 22, 1994

Serial No. 103–25

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INTEREST RATES, WAGES, EMPLOYMENT, AND INFLATION

WEDNESDAY, JUNE 22, 1994

HOUSE OF REPRESENTATIVES,
COMMITTEE ON THE BUDGET,
Washington, DC.

The committee met, pursuant to call, at 10:05 a.m., Room 210, Cannon House Office Building, Hon. Martin Olav Sabo, Chairman, presiding.

Members present: Representatives Sabo, Wise, Stenholm, Frank, Orton, Pomeroy, Browder, Kasich, McMillan, Shays, Snowe, Smith of Texas, Cox, Allard, Hobson, Lazio, Smith of Michigan, Inglis and Hoke.

Chairman SABO. The committee will come to order.

Today, we are meeting with the Chairman of the Federal Reserve Board, Alan Greenspan, to discuss the current state of the economy with special emphasis on the relationship between interest rates, wages, employment and inflation. As many of you know, we didn't get a chance to hear from Chairman Greenspan during the regular course of our Budget Committee hearings this year because of scheduling problems, so we are very interested in what he has to say today.

Mr. Greenspan, it appears from all indicators we are in the midst of a good solid economic recovery. The budget policies we passed last year appear to be working remarkably well. Looks like the deficit this year will be $85 to $95 billion below what it was just 2 years ago, and it is continuing on a downward path for the next 2 years. After that, it will depend on what we do with health care reform, but from all appearances the budget we passed last year is working better than we planned.

We are also seeing remarkable improvements in productivity growth in the private sector. And in almost every segment of the economy it seems to be showing improvement. Nevertheless, we continue to have certain nagging problems.

One that has particularly concerned me is the question of income polarization in this country. I have been concerned about that for several years. I suspect some folks may be getting tired of hearing me talk about it. I think it is a very fundamental problem we face.

It was suggested to me over the years that once the economy improved and productivity improved that the problem would lessen. However, as I look at what is happening in the economy today—we have a strong recovery and dramatic improvements in productivity, and the gap between high-income earners and low-income workers seems to be growing larger.

It would appear to me that recent interest rate increases could make this problem worse. These increases come at a time when that polarization is still pronounced and we still appear to have an excess supply of labor in our labor force. Should we be putting the brakes on the economy when we still have so many people who are either unemployed or underemployed? Could you explain to us what you were trying to accomplish with the rate increases? Did they work as you anticipated?

Do you look at unemployment, and the nature of the labor force when you make these interest rate changes? And to what degree does the Fed concern itself with income polarization in this country as you make your monetary policy? What is the relationship between fighting inflation and promoting employment and higher incomes for workers as we develop monetary policy in this country?

We clearly are also interested in whatever comments you might have as we find analysis of the question of the relationship of the dollar to other international currency, particularly the yen and the mark. Obviously, since we scheduled this hearing, the value of the dollar has been dropping. Any reaction you might have, any analysis you might have or any suggestions for dealing with that problem that might be on your mind we would appreciate hearing.

Mr. Kasich?

Mr. KASICH. Thank you, Mr. Chairman.

On February 8, Mr. Chairman, one of our colleagues, Lucien Blackwell, stated here during a hearing, and I quote: "Over a year ago, I made the observation that this President had the right idea in terms of getting this economy moving. But I also made the observation that, once we started, I was afraid the Federal Reserve System—the fact that we could get something going and in one fell swoop they could just wipe it out. We have a small increase in the economy, create a few jobs. Here comes the Federal Reserve System. We are going to have to do something about raising short-term interest rates because we are afraid that inflation is around the corner."

Essentially, I guess what Mr. Blackwell is arguing is as soon as everybody starts to come to the party he is afraid you are the rainmaker and will drive everybody off the grounds of this party once people are starting to have some fun.

You, as you know, have been the subject of a host of criticism. Some people say that you have raised rates too high, and there is no reason for it. Other people have said that you have had your foot on the gas pedal and been very accommodative with monetary policy because of the Clinton plan. You wanted to make sure it was going to be successful. You put your foot on the gas, and that is why now you are forced to raise rates three or four times.

Other people say you have raised rates too high. You should have been more moderate in it. Other people will argue the M–1 has exploded. The growth in the M–1, the money supply, has been too much. That is why we see this inflation.

I suppose maybe some of those criticisms are right, and all of those arguments, to some point, have validity to them. You could make the arguments about M–1. You could make arguments about interest rates. But your job, Mr. Chairman, as charged by the Congress, is to provide for the maximum amount of economic growth.

Your job is to provide for the greatest increase in employment and prosperity in this country with stable prices—with stable prices. That is the charge that the Congress created and gave to the Federal Reserve when it was established.

And I think the issue today—because you are going to have a lot of people err on the side that you raised rates too high. I am going to be very interested in the charges they make and very interested in your response.

But I think there is a bigger issue today. The bigger issue today is what policies can we as the Congress put in place that will create or will improve an infrastructure in this country that can accommodate more rapid economic growth? When I say infrastructure, I am talking about plant, equipment; and I am talking about human resources, people.

What is it that we can do to create an environment or an infrastructure in this country where we can have faster economic growth, more job creation over a longer period of time?

It is kind of like an automobile. If an automobile has very poor tires on it, it cannot go as fast as an automobile with new tires on it. As a car accelerates, it becomes more dangerous. The higher the car goes with poor tires, the more dangerous it is to be in that car.

The question is, what can we do to improve the situation with that car? What can we do to put new tires on that car so that we can accelerate prosperity in this country?

That is really the question we need to talk about today. Monetary policy is important; but we have to spend some time, a lot of time, talking about fiscal policy.

Frankly, Mr. Chairman, raising taxes last year I think was a terrible mistake. The reason is, it creates a bigger government.

And, in addition, Mr. Chairman, I think that some people in the business community say, well, you know, if we have to have deficit reduction we ought to raise taxes. The problem with people in the business community is that they do not understand that Congress will spend whatever they tax. They will not use it to reduce the deficit.

I think we need to move today to reduce the deficit further. If there is anything that the financial markets would react to positively, it is a Congress that can convince them that we are, in fact, in favor of limited government, and we want to move now to head off what are dramatic increases in the budget deficit in the outyears. What happens to last year? This year?

It is good that we have seen deficits come down, obviously; but what people are worried about and what they are betting on is the fact that Congress in the outyears is not capable of being able to control itself.

We should provide incentives to reduce the costs of capital in this country. Things like accelerated depreciation, neutral cost recovery, lower capital gains taxes, the elimination of double taxation, these are things Republicans have been criticized for over the years. Why do we favor it? Because we believe that lowering the cost of capital will improve the infrastructure so that you, Mr. Chairman, can be in a position to provide for more rapid economic growth, more job creation in line with stable prices.

We think there ought to be deregulation and privatization. Deregulate, privatize things like the FAA, the naval petroleum reserve, excess Federal lands. We think you should provide incentives to save and invest like IRAs. We should correct the Tax Code that encourages debt rather than equity. And we have to scale back the whole size and scope of the Federal Government and have real training for the American people—not done by government but incentives in the private sector to improve our infrastructure.

This, I think, Mr. Chairman, is what we need to focus on here. In addition to the charges that will be leveled at you today about monetary policy, fiscal policy cannot be ignored. In fact proper fiscal policy can be the engine that improves the infrastructure and fundamentally helps Americans to have higher levels of prosperity, that we can have faster economic growth in line with stable prices.

In my questions, Mr. Chairman, I am going to ask you about some of these plans to reduce the cost of the capital and also about your view on a health care plan that could explode the Federal deficit and a health care plan that creates a giant new entitlement based on the hope that Congress will be able to control itself in the outyears.

Mr. Chairman, I appreciate this hearing. I think it is a very important one.

Dr. Greenspan, I welcome you here this morning and look forward to this testimony.

Chairman SABO. Thank you.

Dr. Greenspan, let me just make one quick comment before I yield the floor to you, just so we have some accuracy of history.

The impact of what the Congress did in fiscal policy in this country was very substantial deficit reduction from the history of the 1980's. As a matter of fact, the deficit is coming down substantially more than what we projected a year ago.

It is also not a program that built the Federal Government. As a matter of fact, it is providing for a very substantial reduction in the size and scope of the Federal Government, a reduction of over 250,000 Federal employees over the next several years from the record heights of Federal employment. Maybe not record heights that occurred during the 1980's. I suspect at certain times they were higher. But significant reduction in the Federal work force from what existed through the 1980's.

Dr. Greenspan, we welcome you. We look forward to your comments.

STATEMENT OF HON. ALAN GREENSPAN, CHAIRMAN, BOARD OF GOVERNORS OF THE FEDERAL RESERVE SYSTEM

Mr. GREENSPAN. Thank you very much, Mr. Chairman.

Mr. Chairman, as you know, foreign exchange markets have been the focus of considerable attention in recent days. I do not intend to discuss these developments in my testimony this morning. However, I thought it would be appropriate to inform the committee that Secretary Bentsen and I have been following developments very closely because we cannot be indifferent to major movements in our currency.

Mr. Chairman, I have an extended prepared text and request that the full text be presented for the record, and I will excerpt parts of the statement.

Chairman SABO. The entire statement will be put in the record.

Mr. GREENSPAN. Thank you very much.

Mr. Chairman, members of the committee, I appreciate this opportunity to appear before you to discuss recent monetary policy actions and issues related to inflation.

The Federal Reserve's moves to increase short-term interest rates this year are most appropriately understood in a historical context.

In the spring of 1989, we began to ease monetary conditions as we observed the consequence of balance sheet strains resulting from increased debt along with significant weakness in the collateral underlying that debt. Households and businesses became much more reluctant to borrow and spend and lenders to extend credit, a phenomenon often referred to as the "credit crunch."

In an endeavor to defuse these financial strains, we moved short-term rates lower in a long series of steps that ended in the late summer of 1992, and we held them at unusually low levels through the end of 1993, both absolutely, and importantly, relative to inflation. These actions, together with those to reduce Federal budget deficits, facilitated a significant decline in long-term rates as well.

Lower interest rates fostered a dramatic improvement in the financial condition of borrowers and lenders. The sharp, sustained decline in debt service charges and the restructuring of balance sheets alleviated the financial distress, enabling the economy to begin to move again in a normal expansionary pattern.

By last summer, the likelihood that the economy would soon respond more vigorously to these financial developments already was evident both to the Federal Reserve and to outside analysts. Indeed, in testimony to the Congress at that time, I mentioned that, with short-term real rates not far from zero, "market participants anticipate that short-term real rates will have to rise as the headwinds diminish if substantial inflationary imbalances are to be avoided." But lingering questions into the second half of 1993 about whether the economy had fully recuperated made the appropriate timing of such action unclear.

Since the latter part of 1993, however, the expansionary effects of the monetary policy of the past few years, along with a healing of balance sheets, have become increasingly apparent. Given the stronger economic and financial conditions, it became evident by early 1994 that the mission of monetary policy of the last few years had been accomplished. The headwinds have been substantially reduced, and the expansion appeared solid and self-sustaining.

Having met our objective, there seemed no reasonable purpose in maintaining the demonstrably stimulative level of short-term interest rates held throughout 1993. Maintenance of that degree of accommodation, history shows, would have posed an unacceptable risk of mounting inflationary pressures. Given the resumption of more normal patterns of economic activity and credit flows, a shift in policy stance was clearly indicated.

In early February, we initiated the process of withdrawing the degree of monetary stimulus. At the time, we thought long-term

rates would move a little higher temporarily as we tightened, but that anticipation was in the context of expectations of a more moderate pace of economic activity both here and abroad than emerged shortly thereafter.

The subsequent dramatic rise in market expectations of economic growth here and abroad and associated concerns about inflation provided considerable impetus to the sharp jump in rates. Given the changes in economic conditions and prospects, and the market's perception of them, longer-term rates eventually would have increased significantly even had the Federal Reserve done nothing this year.

Some critics of our latest policy actions have noted that we tightened policy even though inflation had not picked up. That observation is accurate, but it is not relevant to policy decisions. To be successful, we must implement the necessary monetary policy adjustments well in advance of the potential emergence of inflationary pressures so as to forestall their actual occurrence. Shifts in the stance of monetary policy influence the economy and inflation with a considerable lag, as long as a year or more. The challenge of monetary policy is to interpret current data on the economy and financial markets with an eye to anticipating future inflationary or contractionary forces and to countering them by taking action in advance. Indeed, if we are successful in our current endeavors, there will not be an increase in overall inflation. The trend toward price stability will be extended in the context of sustainable growth in economic activity.

Mr. Chairman, in your letter of invitation, you raised a number of questions that relate to the issue of resource restraints and their influence on inflationary pressures. These relationships are not simple. High levels of resource utilization can contribute to the process that ultimately produces destabilizing inflation, but they need not do so.

Indeed, through much of this Nation's history, we had periods of tightened labor and product markets with only transitory effects on the general price level. In these periods, the discipline on credit expansion provided by the gold standard or other institutional arrangements limited the potential for prices to spiral upward and thus kept long-term inflation expectations from rising.

After World War II, however, with those disciplines no longer in place, tightened markets became increasingly associated with rising inflation expectations and burgeoning credit demands which we were sometimes too slow to counter. A persistent inflation, unprecedented in our history, eventually took hold with devastating effects on our economy and society. We still are paying the price for that episode, despite major successes in reversing inflationary pressures during the past 15 years.

There remains a significant inflation premium embodied in long-term interest rates, reflecting a still skeptical world financial market view that American fiscal and monetary policies retain some inflation bias. Until the late 1970's, the markets held a deep-seated, though, in retrospect, naive view that the economic and institutional structure of the United States rendered us particularly immune from persistent inflationary forces. When that view was shattered by the reality of the late 1970's, bond markets collapsed.

Much progress has been made in restoring the degree of confidence that existed earlier in the post-World War II period, but it has taken years. Moreover, judging from the remaining inflation premium embodied in long-term rates, the job is not yet complete. Having paid so large a price in reversing inflation processes to date, it is crucial that we do not allow them to reemerge.

Mr. Chairman, with respect to your question about the so-called "natural rate" of unemployment, some analysts have suggested that unemployment relative to its natural rate can be used as a means of quantifying the aggregate demand-aggregate supply balance.

The "natural rate" is usually defined as the rate of unemployment consistent with no tendency for the inflation rate to move up or down over time. Any attempt by monetary or fiscal policy to hold the unemployment rate permanently below the "natural" rate, it is argued, would require increasing amounts of monetary accommodation that in the end would only succeed in pushing inflation continually upward. The record of the postwar period suggests that episodes of tightness in the labor market have been associated with increases in the rate of inflation, and the converse. But over the longer term, no trade-off is evident between inflation and unemployment.

While the idea of a national "threshold" at which short-term inflation rises or falls is statistically appealing, it is very difficult in practice to arrive at useful estimates that would identify such a natural rate. In large measure, these difficulties result from the enormous complexity and dynamism of our labor markets. Evolving demographic trends and changes in the geographical distribution of activity can alter the degree of short-term pressure on wages that is associated with any given measure of aggregate unemployment. Moreover, structural shifts in the pattern of demand across industries and occupations can also influence the so-called natural rate.

In addition to the continual flux that is an integral element of our market economy, public policies—intentionally or unintentionally—can raise or lower the natural rate depending on whether they hinder or facilitate adjustment in labor markets. Arriving at an overall assessment of these influences is far from straightforward and likely accounts for the wide range of estimates among professional economists. When the statistical uncertainty associated with these estimates is taken into account, a plausible "confidence interval" is likely even wider.

In light of these uncertainties, I do not think that any one estimate of a natural rate is useful in the formulation of monetary policy. We clearly have entered a period in which economic policymakers need to watch carefully for signs of resource pressures in the labor market. But appropriate analysis of current and prospective conditions will need to extend beyond the aggregate figures for the labor market alone and address regional and skill differences as they apply to wage determination.

Mr. Chairman, in addition to labor, the answers to your questions about our capacity for noninflationary growth will depend on the expansion of the Nation's stock of plant and equipment and, most importantly, ideas.

The Federal Reserve's own index of output capacity in manufacturing increased 2¼ percent last year and is likely to surpass that performance in 1994. The Federal Reserve's indexes define capacity as the highest level of output that a plant can maintain within the framework of a realistic work schedule, that is, one that allows for normal downtime and sufficient availability of inputs. The Fed capacity estimates are developed from a variety of sources, including capacity measures in physical units compiled by trade associations as well as surveys of utilization rates as perceived by individual companies.

But businesses have the ability over time to respond to changing market conditions. When demand is picking up, firms historically have been able to "stretch" capacity by working their capital and labor overtime. The ability to import raw materials, components, or even final products from assembly plants abroad also can help at times to meet unexpected growth in demand. However, this is unlikely to be a permanent solution because increased demand pressures abroad as global activity recovers and expands will tend over time to push up import prices and eliminate any temporary cost advantage. At this point, we have little aggregate evidence that the increased openness of the U.S. economy over the past several decades has substantially altered the process of domestic price formation.

The rate of capacity utilization in manufacturing, a measure of the pressure on the domestic production of goods, was a shade under 83 percent in May, well above its historical average. However, as with the unemployment rate, there is no clear-cut, so-called "trigger point" for capacity utilization as a signal for emerging inflationary pressures. To be sure, as capacity utilization increases, bottlenecks occur with greater frequency and production costs rise. Indeed, the recent firming of prices of some products and raw materials suggests that we may already be witnessing some elements of this process. To date, however, owing to constrained increases in unit labor costs, broad measures of producer prices for final goods have not generally reflected the increases in those input costs. In addition, monetary and credit growth remains quite muted. But further increases in pressure on manufacturing facilities might suggest a greater risk of emerging inflationary imbalances.

Of course, aggregate price trends obscure considerable diversity across industries in the relationship of capacity to prices. For example, operating rates are high in the motor vehicle and computer-related industries. The prices of light trucks have risen, while the prices of microprocessors have plunged. Such differences make it very difficult at the aggregate level to pin down a particular level of capacity utilization that can be associated with the emergence of inflation pressures. All told, the rate of capacity utilization in manufacturing is not a foolproof measure of inflation pressures. But, like the unemployment rate, its level and trajectory deserve close attention.

The efficiency with which our labor and capital resources are combined also has had an important influence on the aggregate supply potential of the economy, and the recent record here is cause for some optimism.

It is important to remember that growth in productivity is the key to increases in our standard of living over time.

Finally, it is germane to ask what economic policymakers can do to foster faster growth of aggregate supply and thereby raise the threshold of resource utilization. In this regard, the role of monetary policy is rather narrow but potentially potent.

Most importantly, we can reinforce ongoing trends in the private sector and enhance our productive potential by helping to create a stable environment for sustainable, noninflationary economic growth. Stability in economic conditions boosts confidence and makes long-run planning by businesses and households much easier. In that regard, the maintenance of inflation sufficiently low that it need not be a factor in business and consumer decisionmaking enhances the operation of the market price mechanism and helps to ensure that resources are used most productively.

Inflation interferes with such price signals and spawns the wasteful use of resources to hedge against unexpected price changes. Experience both here and abroad suggests that lower levels of inflation are conducive to the achievement of greater productivity and efficiency and, therefore, higher standards of living. In fact, there is some, but by no means definitive, evidence that lower rates of inflation have been associated not just with higher levels of productivity but with faster growth of productivity as well.

Owing to the increasing evidence of the deleterious effects of inflation, in recent years there has emerged a growing consensus throughout the world that a monetary policy geared towards the pursuit of price stability over time is the central bank's most significant contribution to achieving maximal growth of the Nation's well-being.

The actions undertaken by Congress also can have profound effects on the inflation threshold of our economy and its productive potential. Clearly, we ought to be encouraging measures to increase the flexibility of our work force and labor markets. Improving education and facilitating better and more rapid matching of workers with jobs are essential elements in making more effective use of the U.S. labor force.

Just as important, Congress should avoid enacting policies that create impediments to the efficient movement of individuals across regions, industries and occupations or that unduly discourage the hiring of those seeking work. Competitive markets have shown a remarkable ability to create rising standards of living when left free to function.

Finally, the Congress and the administration can continue to contribute to the growth of our economy by the maintenance of a disciplined fiscal policy. Last year's budget agreement, especially the spending caps, was a significant step in putting fiscal policy on a more sustainable long-term path. But, as this committee fully understands, under current policy and law, later in this decade Federal outlays will almost surely again be rising at a pace that will exceed the growth of our tax base. Unless addressed, these trends will lead to increases in the deficit as a percent of gross domestic product, with unacceptable consequences for financial stability and economic growth. As I indicated to this committee last year, in-

creases in tax rates cannot solve this problem. Only by reducing the growth in spending is ultimate balance achievable.

In summary, Mr. Chairman, despite these considerable policy challenges and the always present future uncertainties, the outlook for the U.S. economy is as bright as it has been in decades. Economic activity has strengthened, unemployment is down, and price trends have remained subdued. In addition, unlike some earlier periods, business spending on new plant and equipment has been an important contributor to growth. This strength in investment will enhance economic efficiency and lay the foundation for the productivity gains that will bolster the economic welfare of our Nation. The Federal Reserve welcomes these developments because the intent of our monetary policy in recent years has been to foster precisely this kind of healthy economic performance.

Thank you very much, Mr. Chairman.

[The prepared statement of Hon. Alan Greenspan follows:]

PREPARED STATEMENT OF HON. ALAN GREENSPAN, CHAIRMAN, BOARD OF GOVERNORS OF THE FEDERAL RESERVE SYSTEM

Mr. Chairman and members of the Committee, I appreciate the opportunity to appear before you to discuss recent monetary policy actions and issues related to inflation.

The Federal Reserve's moves to increase short-term interest rates this year are most appropriately understood in an historical context.

In the spring of 1989, we began to ease monetary conditions as we observed the consequence of balance-sheet strains resulting from increased debt, along with significant weakness in the collateral underlying that debt. Households and businesses became much more reluctant to borrow and spend, and lenders to extend credit—a phenomenon often referred to as the "credit crunch." In an endeavor to defuse these financial strains, we moved short-term rates lower in a long series of steps that ended in the late summer of 1992, and we held them at unusually low levels through the end of 1993—both absolutely and, importantly, relative to inflation. These actions, together with those to reduce federal budget deficits, facilitated a significant decline in long-term rates as well.

Lower interest rates fostered a dramatic improvement in the financial condition of borrowers and lenders. The sharp, sustained decline in debt-service charges and the restructuring of balance sheets alleviated the financial distress, enabling the economy to begin to move again in a normal expansionary pattern. By last summer, the likelihood that the economy would soon respond more vigorously to these financial developments already was evident both to the Federal Reserve and to outside analysts. Indeed, in testimony to the Congress at that time I mentioned that, with short-term real rates not far from zero, "...market participants anticipate that short-term real interest rates will have to rise as the headwinds diminish if substantial inflationary imbalances are to be avoided." But lingering questions into the second half of 1993 about whether the economy had fully recuperated made the appropriate timing of such action unclear.

Since the latter part of 1993, however, the expansionary effects of the monetary policy of the past few years along with the healing of balance sheets have become increasingly apparent. Given the stronger economic and financial conditions, it became evident by early 1994 that the mission of monetary policy of the last few years had been accomplished. The "headwinds" were substantially reduced, and the expansion appeared solid and self-sustaining.

Having met our objective, there seemed no reasonable purpose in maintaining the demonstrably stimulative level of short-term interest rates held throughout 1993. Maintenance of that degree of accommodation, history shows, would have posed an unacceptable risk of mounting inflationary pressures. Given the resumption of more normal patterns of economic activity and credit flows, a shift in policy stance was clearly indicated.

In early February, we initiated the process of withdrawing the degree of monetary stimulus. At the time, we thought long-term rates would move a little higher temporarily as we tightened, but that anticipation was in the context of expectations of a more moderate pace of economic activity both here and abroad than emerged shortly thereafter. The subsequent dramatic rise in market expectations of economic

growth here and abroad and associated concerns about inflation provided considerable impetus to the sharp jump in rates. Given the changes in economic conditions and prospects. and the market's perception of them, longer-term rates eventually would have increased significantly even had the Federal Reserve done nothing this year.

The rise in long-term rates has reflected increased uncertainty, as well as expectations of a stronger economy. While generally expected, the move from accommodation, interacting with the news on the domestic and global economy, triggered a reexamination by investors of their overly sanguine assumptions about price risk in longer-term financial assets. As volatility and uncertainty increased, investors here and abroad began to reverse their previous maturity extensions. They fled toward more price-certain investments at the short end of the yield curve. For example, some flows into bond mutual funds were reversed; investors, fearing further rate increases and awakening to the nature of the risk they had taken on, shifted funds back into shorter-term money market mutual funds and into deposits. The sales of securities by bond mutual funds likely contributed to pressures on yields, especially in markets in which they had been important buyers.

Because we at the Fed were concerned about sharp reactions in markets that had grown accustomed to an unsustainable combination of high returns and low volatility, we chose a cautious approach to our policy actions, moving by small amounts at first. Members of the Federal Open Market Committee agreed that excess monetary accommodation had to be eliminated expeditiously. We recognized, however, that our shift could impart uncertainty to financial markets, and many of us were concerned that a large immediate move in rates would create too big a dose of uncertainty, which could destabilize the financial system, indirectly affecting the real economy. In light of the substantial variations in prices of financial assets over the past few months as we adjusted our posture, our worries seem to have been justified. But, through this period, many of those who had purchased long-term securities with unduly optimistic expectations about the level and fluctuations in yields had made the needed adjustments. Thus, we judged at our May 17th meeting that we could initiate a larger adjustment, without an undue adverse market reaction. Indeed, markets reacted quite positively, on balance, at that time, perhaps because they saw such timely action as reducing the degree and frequency of tightening that might be needed in the future.

Some critics of our latest policy actions have noted that we tightened policy even though inflation had not picked up. That observation is accurate, but is not relevant to policy decisions. To be successful, we must implement the necessary monetary policy adjustments well in advance of the potential emergence of inflationary pressures, so as to forestall their actual occurrence. Shifts in the stance of monetary policy influence the economy and inflation with a considerable lag, as long as a year or more. The challenge of monetary policy is to interpret current data on the economy and financial markets with an eye to anticipating future inflationary or contractionary forces and to countering them by taking action in advance. Indeed, if we are successful in our current endeavors, there will be an increase in overall inflation. The trends toward price stability will be extended in the context of sustainable growth in economic activity.

Mr. Chairman, in your letter of invitation, you raised a number of questions that relate to the issue of resource restraints and their influence on inflationary pressures. These relationships are not simple. High levels of resource utilization can contribute to the process that ultimately produces destabilizing inflation, but they need not do so.

Indeed, through much of this nation's history, we had periods of tightened labor and product markets with only transitory effects on the general price level. In these periods the discipline on credit expansion provided by the gold standard or other institutional arrangements limited the potential for prices to spiral upward and thus kept long-term inflation expectations from rising. After World War II, however, with those disciplines no longer in place, tightened markets became increasingly associated with rising inflation expectations and burgeoning credit demands, which we were sometimes too slow to counter. A persistent inflation, unprecedented in our history, eventually took hold, with devastating effects on our economy and society.

We still are paying a price for that episode despite major successes in reversing inflationary pressures during the past 15 years. There remains a significant inflation premium embodied in long-term interest rates, reflecting a still skeptical world financial market view that American fiscal and monetary policies retain some inflation bias. Until the late 1970s, the markets held a deep-seated though, in retrospect, naive view that the economic and institutional structure of the United States rendered us particularly immune from persistent inflationary forces. When that view was shattered by the reality of the late 1970s, bond markets collapsed. Much

progress has been made in restoring the degree of confidence that existed earlier in the post World War II period, but it has taken years. Moreover, judging from the remaining inflation premium embodied in long-term rates, the job is not yet complete. Having paid so large a price in reversing inflation processes to date, it is crucial that we do not allow them to re-emerge.

Mr. Chairman, with respect to your question about the so called "natural rate" of unemployment, some analysts have suggested that unemployment relative to its natural rate can be used as a means of quantifying the aggregate demand-aggregate supply balance. The "natural rate" is usually defined as the rate of unemployment consistent with no tendency for the inflation rate to move up or down over time. Any attempt by either monetary or fiscal policy to hold the unemployment rate permanently below the "natural" rate, it is argued, would require increasing amounts of monetary accommodation that, in the end, would only succeed in pushing inflation continually upward. The record of the postwar period suggests that episodes of tightness in the labor market have been associated with increases in the rate of inflation, and the converse. But over the longer term, no trade-off is evident between inflation and unemployment.

While the idea of a national "threshold" at which short-term inflation rises or falls is statistically appealing. it is very difficult in practice to arrive at useful estimates that would identify such a natural rate. In large measure, these difficulties result from the enormous complexity and dynamism of our labor markets. Evolving demographic trends and changes in the geographical distribution of activity can alter the degree of short-term pressure on wages that is associated with any given measure of aggregate unemployment. Moreover, structural shifts in the pattern of demand across industries and occupations can also influence the so-called natural rate. In addition to the continual flux that is an integral element of our market economy, public policies—intentionally or unintentionally—can raise or lower the natural rate depending on whether they hinder or facilitate adjustment in labor markets. Arriving at an overall assessment of these influences is far from straightforward and likely accounts for the wide range of estimates among professional economists. When the statistical uncertainty associated with these estimates is taken into account, a plausible "confidence interval" is likely even wider.

At present, assessments of the state of the labor market have been complicated by the revision this year to the Current Population Survey. Based on initial tests of the new questionnaire and collection techniques by the Bureau of Labor Statistics, it appeared that the changes likely would raise our statistical measure of the unemployment rate. In response, many analysts have increased their estimates of the natural rate by the presumed difference between the old and new surveys. But a variety of technical issues remain unresolved, and it may be a long time before we know with any certainty the influence of these changes on the measured unemployment rate.

In light of these uncertainties, I do not think that any one estimate of the natural rate is useful in the formulation of monetary policy. We clearly have entered a period in which economic policymakers need to watch carefully for signs of resource pressures in the labor market. But, appropriate analysis of current and prospective conditions will need to extend beyond the aggregate—figures for the labor market alone and address regional and skill differences as they apply to wage determination.

Mr. Chairman, in addition to labor, the answers to your questions about our capacity for noninflationary growth will depend on the expansion of the nation's stock of plant and equipment and, most importantly, ideas. Investment spending not only raises the amount of capital per worker—an essential determinant of labor productivity—but also is a principal channel through which new technologies are introduced into the production process. Today, we are in the midst of a capital spending boom, as companies strive to modernize existing plants and add capacity. Investment in computers and high-tech communications equipment has been particularly strong, stimulated by waves of technological improvement and rapidly expanding opportunities for the application of these technologies. But demand for more traditional types of industrial machinery also has been strong, and the construction of new production facilities has revived. This strength in capital spending has been driven by the relatively low level of financing costs and by the conviction within the business community that, with favorable prospects for a steady expansion of the economy, the risks in adding capacity are acceptable.

The Federal Reserve's own index of output capacity in manufacturing increased 2¼ percent last year and is likely to surpass that performance in 1994. The Federal Reserve's indexes define capacity as the highest level of output that a plant can maintain within the framework of a realistic work schedule, that is, one that allows for normal downtime and sufficient availability of inputs. The Fed capacity esti-

mates are developed from a variety of sources, including capacity measures in physical units compiled by trade associations, as well as surveys of utilization rates as perceived by individual companies.

But businesses have the ability over time to respond to changing market conditions. When demand is picking up, firms historically have been able to "stretch" capacity by working their capital and labor overtime. The ability to import raw materials, components, or even final products from assembly plants abroad, also can help at times to meet unexpected growth in demand. However, this is unlikely to be a permanent solution because increased demand pressures abroad as global activity recovers and expands will tend over time to push up import prices and eliminate any temporary cost advantage. At this point, we have little aggregate evidence that the increased openness of the U.S. economy over the past several decades has substantially altered the process of domestic price formation.

The rate of capacity utilization in manufacturing—a measure of the pressure on the domestic production of goods—was a shade under 83 percent in May—well above its historical average. However, as with the unemployment rate, there is no clear-cut "trigger point" for capacity utilization as a signal for emerging inflationary pressures. To be sure, as capacity utilization increases, bottlenecks occur with greater frequency, and production costs rise. Indeed, the recent firming of prices of some products and raw materials suggests that we may already be witnessing some elements of this process. To date, however, owing to constrained increases in unit labor costs, broad measures of producer prices for final goods have not generally reflected the increases in those input costs. In addition, monetary and credit growth remains quite muted. But, further increases in pressure on manufacturing facilities might suggest a greater risk of emerging inflationary imbalances.

Of course, aggregate price trends obscure considerable diversity across industries in the relationship of capacity utilization to prices. For example, operating rates are high in the motor vehicle and computer-related industries. Yet the prices of light trucks have risen, while the prices of microprocessors have plunged. Such differences make it very difficult at the aggregate level to pin down a particular level of capacity utilization that can be associated with the emergence of inflation pressures. All told, the rate of capacity utilization in manufacturing is not a fool-proof measure of inflation pressures. But, like the unemployment rate, its level and trajectory deserve close attention.

The efficiency with which our labor and capital resources are combined also has an important influence on the aggregate supply potential of the economy, and the recent record here is cause for some optimism. Since the last business cycle peak in the summer of 1990, labor productivity—output per hour in the nonfarm business sector—has increased, on average, at about a 2 percent annual rate. At this stage, disentangling trend from cycle remains difficult. But there are some signs of improvement in our underlying productivity performance in response to increased global and domestic competition and improved management. In addition, the investment in high-tech equipment now finally appears to be paying off. It has taken businesses time to learn how to use computers effectively in their operations. But better hardware and significant advances in software now are permitting many companies to "re-engineer" the way they produce and distribute goods and services.

It is important to remember that growth in productivity is the key to increases in our standard of living over time. Productivity is the essential element that allows wages to grow in a noninflationary way. It is for this reason that over long periods of time broad measures of compensation per hour, which include both wages and benefits, closely track the trend in labor productivity, when compensation is measured relative to the prices of the goods and services produced in the U.S. economy. Thus, if maintained, the strong growth in labor productivity in this expansion will be a very welcome development indeed.

Finally, it is germane to ask what economic policymakers can do to foster faster growth of aggregate supply and thereby raise the threshold of resource utilization. In this regard, the role of monetary policy is rather narrow, but potentially potent. Most importantly we can reinforce ongoing trends in the private sector that enhance our productive potential by helping to create a stable environment for sustainable noninflationary economic growth. Stability in economic conditions boosts confidence and makes longrange planning by businesses and households much easier. In that regard, the maintenance of inflation sufficiently low that it need not be a factor in business and consumer decisionmaking enhances the operation of the market price mechanism and helps to ensure that resources are used most productively. Inflation interferes with such price signals and spawns the wasteful use of resources to hedge against unexpected price changes. Experience both here and abroad suggests that lower levels of inflation are conducive to the achievement of greater productivity and efficiency and, therefore, higher standards of living. In fact, there is some, but by

no means definitive, evidence that lower rates of inflation have been associated not just with higher *levels* of productivity, but with faster *growth* of productivity as well. Owing to the increasing evidence of the deleterious effects of inflation, in recent years there has emerged a growing consensus throughout the world that a monetary policy geared towards the pursuit of price stability over time is the central bank's most significant contribution to achieving maximal growth of a nation's well being.

The actions undertaken by Congress also can have profound effects on the inflation threshold of our economy and its productive potential. Clearly, we ought to be encouraging measures to increase the flexibility of our workforce and labor markets, improving education and facilitating better and more rapid matching of workers with jobs are essential elements in making more effective use of the U.S. labor force. Just as important, Congress should avoid enacting policies that create impediments to the efficient movement of individuals across regions, industries, and occupations, or that unduly discourage the hiring of those seeking work. Competitive markets have shown a remarkable ability to create rising standards of living when left free to function.

Finally, the Congress and the Administration can continue to contribute to the growth of our economy by the maintenance of a disciplined fiscal policy. Last year's budget agreement, especially the spending caps, was a significant step in putting fiscal policy on a more sustainable long-run path. But, as this Committee fully understands, under current policy and law, later in this decade federal outlays will almost surely again be rising at a pace that will exceed the growth of our tax base. Unless addressed, these trends will lead to increases in the deficit as a percent of GDP, with unacceptable consequences for financial stability and economic growth. As I indicated to this Committee last year, increases in tax rates cannot solve this problem. Only by reducing the growth in spending is ultimate balance achievable.

In summary, despite these considerable policy challenges and the always present future uncertainties, the outlook for the U.S. economy is as bright as it has been in decades. Economic activity has strengthened, unemployment is down, and price trends have remained subdued. In addition, unlike some earlier periods, business spending on new plant and equipment has been an important contributor to growth. This strength in investment will enhance economic efficiency and lay the foundation for the productivity gains that will bolster the economic welfare of our nation. The Federal Reserve welcomes these developments because the intent of our monetary policy in recent years has been to foster precisely this kind of healthy economic performance.

Mr. WISE [presiding]. Chairman Greenspan, thank you very much.

Chairman Sabo extends his apologies. He had to go to the Appropriations Committee.

I would remind all members that Chairman Greenspan must leave at noon, so we will try to move along under the 5-minute rule as much as possible so everyone can have their contribution.

Did you all hear that in the back? Fine.

So at this point, since I arrived late, I will defer my time to those who arrived more timely than I did.

We will first recognize the gentleman from Texas, Mr. Stenholm, for 5 minutes.

Mr. STENHOLM. Thank you, Mr. Chairman.

Chairman Greenspan, you gave a lot of emphasis to the need of controlling inflation and stated in your statement that the Federal Reserve uses that as one of the criteria in setting your interest rates.

Many experts have concluded that the CPI currently overstates inflation. Estimates of the degree of miscalculation range from half of 1 percent to 1.5 percent. If so, then that has a distinct effect on your decisionmaking process. It also has a direct effect on spending by the Congress. Every 1 percent mistake leads to roughly $4.5 billion of additional spending that is not justified if the formula is wrong.

My question to you is, do you agree that the current CPI is overstating inflation? And, if so, by how much?

Mr. GREENSPAN. I do, Congressman. I believe I may well have stated this issue before this committee previously, and it is an issue which is well worth emphasizing, specifically for the reasons you suggest.

A number of economists have endeavored to make judgments with respect to the underlying biases in any price index that is created. The figures that you cite, namely somewhere between .5 and 1.5 percent, probably captures most of the variation in the bias that professional economists and statisticians have adduced in the years since the Consumer Price Index came out.

I do think that the Bureau of Labor Statistics is aware that this bias exists. I don't think they hold numbers anywhere near as large as some professional economists, and my experience with them is they are working very diligently to try to eliminate some of these biases. But the biases are very difficult to adjust because they rest in large part on the fact that we are in a very dynamic economy. Products are continuously changing.

The definition of price is a very elusive notion in a number of products, but any success we can have in improving the way we measure our price statistics will have important implications for budget policy for precisely the reason that you, Congressman, are suggesting.

Mr. STENHOLM. I want to refer specifically to your statements that real interest rates should be at some neutral zone. I am interested in the effect, if currently interest rates are 4.2 percent, to what degree inflation is overstated. If it is 2.8 percent today, and if it is overstated by 1 percent, then real inflation is 1.8 percent, that is real interest rates would be somewhere between 1.4 and 2.4 percent.

Where are you in that range as you estimate what inflation is? As you and the rest of the Federal Reserve attempt to judge where interest rates should be which of those inflation factors are you using?

Mr. GREENSPAN. Congressman, we do not have a fixed view at this stage of precisely what the degree of bias is, but we do think there is a bias. It is somewhere in the range which you marked out. We do not see any significant evidence, however, that that range, that bias has changed materially over time.

So to the extent that when one measures real interest rates by effectively subtracting the inflation rate from nominal interest rates, if there is a bias in the inflation rate and it has not changed very significantly, it means that the level of inflation that one subtracts from the nominal interest rate is lower across the board and that the real interest rate is correspondingly higher.

When one is looking at how one evaluates the degree of market effects of various different real interest rates, it really is in the context of history. In that regard, the issue of the bias in the price index is not a relevant consideration unless there is evidence that that bias has a trend to it, and we cannot find such a trend.

Mr. STENHOLM. I judge then you would say that it could be a very constructive endeavor on the part of the Congress if we looked

into this to see whether or not a possible adjustment should be made?

Mr. GREENSPAN. I would certainly say it is the type of thing which is the province of this committee as far as I can see. It does have a significant impact on the budget of the United States.

Mr. STENHOLM. Thank you very much.

Mr. WISE. The gentleman from Ohio, Mr. Kasich.

Mr. KASICH. Mr. Chairman, I appreciate your testimony. Much of what you had to say kind of paralleled what—the statement I made in opening.

Mr. Chairman, let me for a second view with you the question of fiscal policy and fiscal discipline. This is the increase in discretionary spending over the period of the next 5 years. This increase in discretionary——

We have been told how discretionary spending is flat. This, in fact, is the increase in discretionary spending. That represents a line that accelerates pretty dramatically even in light of the fact that we have real declines, not baseline declines but real declines in defense spending. Clearly, this line does not send good signals to people who wonder about Congress being able to control spending.

That is the discretionary side, Mr. Chairman. This is the mandatory side.

Mandatory spending will go from $802 billion to over $1.1 trillion in the year 1999, a dramatic increase in mandatory entitlement spending.

Mr. Chairman, my first question would be, do you think it would be very positive, a positive signal to the financial markets in this country and to the American people, for that matter, for the Congress to move in dramatic fashion to further work to reduce the budget deficit along the lines that many of us, both Republicans and Democrats, have been suggesting over the course of the last year?

Mr. GREENSPAN. Congressman, as I said I believe the last time I was before this committee and on numerous occasions last year when long-term budget issues were being discussed, we surely have some element of inflation premiums embodied in long-term interest rates which are a consequence of the fact that the long-term, turn-of-the-century outlook for our deficit is still quite uncertain with respect to the relationship between spending and the tax base.

And there is no doubt in my mind that, were we to come to grips with that gap, markets would respond in a positive manner. The amount of adjustment is very difficult to judge, and this committee is far more cognizant of the details than I could ever want to be, I suspect, but the data are just too conclusive for the turn-of-the-century to be dismissed.

And I would emphasize what I said last year and in my prepared testimony today, that one cannot effectively address this problem from the tax side because if the rate of growth in underlying spending is faster than that of the tax base you have to increase taxes continuously just to catch up. And, ultimately, that becomes counterproductive, because income generation would falter, and you would not solve a deficit over the long run from the tax side in the

context of the type of problem which currently confronts our long-term projections.

Mr. KASICH. I want to compliment you on your statement where you argue against increasing rates. Many of us have argued this for a long time. I am glad to hear the statement you just made.

Let me ask you another deficit-related question. That involves the issue of this health care plan.

The President argued in his State of the Union address that if he could control health care costs in the outyears, entitlements in the outyears, he would be able to lower the deficit significantly. I happen to agree we need to do something in order to control the deficit.

This is the—the blue line representing what will happen to mandatory spending—I am sorry, to the deficit if, in fact, Mr. Chairman, we do not pass a health care reform bill.

The CBO came out and did an estimate of the Clinton plan. As you can see, with the Clinton plan, the deficit actually increases faster than if we didn't pass the Clinton health care plan.

Mr. Chairman, I have—I have drafted an outline of my own program. One of the things that I have tried to do is to create a plan that—with a goal of universal coverage. Maybe that is a bad definition. To me, it is not——

We want—we do not want health care police knocking on everybody's door. But the fact we have made health care insurance available at affordable costs to every American, which would mean from the lowest income Americans, from a zero to 100 percent of poverty, they would get a health care plan that would be somewhat similar to the current Medicaid system but maybe with a certificate or voucher.

The real tough question is what do you do between 100 and 200 percent poverty to let the poorest Americans be able to purchase health insurance. I will tell you, Mr. Chairman, with a package that is very modest, the cost of being able to provide a full subsidy between zero and 100 percent of poverty and a sliding scale subsidy between 100 and 200 percent of poverty is somewhere—the cost of that package, without any drug benefit, long-term care, anything else, the cost of that package is in excess of $100 billion.

Mr. Chairman, does it make sense to create a health care plan that would call for at least a new entitlement somewhere in the neighborhood in excess of $100 billion immediately? Or should we pass a health care plan that if we have the goal of universal coverage or if we have the attitude or the idea that what we should have is a plan that allows people to be able to purchase health insurance, everybody, should we go on a pay-as-you-go basis and have real rigor?

In other words, savings we would make on one side of the ledger would be used to pay for any new entitlement on the other side of the ledger? Should we do it in a very rigorous way? Or should we do it by mandating it tomorrow?

What impact would it have on the financial markets for the Congress to pass a $100 billion new entitlement program next year that doesn't have the proper funding? What impact would it have across this country?

Mr. GREENSPAN. Congressman, as I said last year, I have chosen not to get involved in the individual elements of the Federal budget but merely to look in terms of some of the broader principles. I have stayed away from discussing the questions of specific programs, whether they be health care or others, because I don't think that this is an appropriate forum for the central bank.

So while, obviously, as a citizen, I have very considerable interest in how this issue ultimately evolves, I have chosen not to be involved with it. I hope you will understand my concerns with respect to that?

Mr. KASICH. I understand.

Mr. Chairman, my only concern about it is if you are going to be creating giant new entitlement programs in this country that leave people confused about how they will be funded, I think it ultimately has a dramatic impact on what happens with our deficits that are outlined in our testimony. I would ask you to rethink this and perhaps make a public statement sometime soon.

Finally, just one last question. Do you believe the tax policy has a role to play in lowering the cost of capital as outlined in your testimony? Can tax policy play a very important role in providing for that infrastructure that I talked about so that we can accommodate faster growth with an expansion of plant equipment? If tax policy does play a role, what kinds of things do you think we should look at in the Congress?

Mr. GREENSPAN. Congressman, I do think it plays a role. I think I discussed that before this committee before. I will repeat what I said then.

I think a major change in tax policy would be, as I have suggested innumerable times in the past, the elimination of the capital gains tax. I think that that serves no productive use in the economy. It does raise the cost of capital. And, in my judgment, were we to eliminate it or, second best, significantly curtail it, we would have significant improvements in the economy which would far exceed whatever loss in revenues people perceive it had, although I am one of those who does not believe that there are revenue losses in the broad context of that type of evaluation.

Mr. WISE. The gentleman from Massachusetts?

Mr. FRANK OF MASSACHUSETTS. Dr. Greenspan, that was such a good answer on that one, he probably will let you off the hook on health care.

I was struck when the gentleman from Ohio said your statement and his had a lot of parallels. I didn't remember his saying anything about the outlook for the U.S. economy being as bright as it has been in decades. Price trends remain subdued. Unemployment is down. Unlike earlier periods, business spending on new plant and equipment has been an important contributor to growth.

I think, frankly, if you took some of the comments by colleagues on the other side of the aisle made a year ago after we were working on the budget and took your comments here you would have the greatest disparity in the history of economics in terms of assessment of a situation. Convergence comes late, but it is always to be encouraged.

You said you didn't want to talk about taxes for the future to lower the deficit. I think that is a legitimate issue. Let me ask you:

One of the predictions we had last year was to the extent we did raise taxes—particularly on upper income people—a fairly small percentage of upper income people—there were predictions that that would have a negative effect on employment. I wonder now that those taxes have gone into effect, there were the figures in April, did we have a very negative effect on employment by the tax portion of last year's budget package?

Mr. GREENSPAN. I would answer that in two ways, Congressman. I would say, one, that in the short run, the answer is no, but I must say I never personally thought that it would have. I think the real——

Mr. FRANK OF MASSACHUSETTS. Where were you when we needed you?

Mr. GREENSPAN. You failed to call me up at the particular time.

The problem, however, with taxation is that you cannot really determine the extent of the impact of taxation's effect on the economy except in retrospect over a number of years. So I would say that the effect of raising marginal tax rates is the type of thing which you do not see immediately. I think——

Mr. FRANK OF MASSACHUSETTS. I appreciate the honesty of that. We had predictions from the other side it would have a short-term negative effect. People were telling us how many jobs would be lost. Your answer is, no, it had no short-term effect. You are agnostic as to the long term. I think that is responsible.

The other point is, your insistence that—not insistence but your comment that inflation at this point appears to be well under control. In particular—I will have to apologize. I think maybe I was misled by the media—it happens from time to time.

But I was pleased to read your disagreement with the argument that there is some natural rate of unemployment, that that is something about a figure which, if we go below, would be inflationary and your repudiation of that and your saying you have to take a look at it. I think that that is very helpful.

I do want to emphasize—we read, again in terms of the currency problems, your view is that in real terms in the economy today inflation, especially after the interest rate raises we have had this year, is—the outlook is reasonably good. Is that correct?

Mr. GREENSPAN. Let me go back to address the tax question.

I do think over the long run taxation tends to be negative to investment. I think the evidence is quite strong.

Mr. FRANK OF MASSACHUSETTS. The type of taxation we did last year will be negative?

Mr. GREENSPAN. If you ask me, ultimately, I would say I would be surprised if it doesn't turn out that way. The evidence at this stage is not in.

Mr. FRANK OF MASSACHUSETTS. To the extent we have evidence, there has been no negative?

Mr. GREENSPAN. As of this point—as of this point, looking at the data, I would say the evidence does not yet exist. If you ask me whether I expected it to show up in the years ahead, I suspect, on the basis of past experience, it probably will.

Mr. FRANK OF MASSACHUSETTS. I would ask you to call me. That is true.

Mr. GREENSPAN. I will be glad to do so.

Mr. FRANK OF MASSACHUSETTS. That is the St. Augustine approach. Not yet, Lord, especially for Greenspan and me.

Mr. GREENSPAN. Let me respond to your question on inflation.

If one looks, basically, at the data that have been reported to date on inflation, we see two things: one, there have been some underlying increases in input costs in the system, but two, unit labor costs have been quite subdued, as I said in my prepared statement. As a consequence, we have not seen any significant increases in final product prices which, ultimately, is what we measure inflation by. The data, however, are through the month of May for all practical purposes.

Mr. FRANK OF MASSACHUSETTS. You did say in your statement you believe, given what you have done so far and the way things have worked so far, that we have a pretty good outlook.

Mr. GREENSPAN. I would say at this particular stage that the outlook looks quite reasonable, and I would emphasize further that monetary policy is dedicated to making sure that it stays there.

Mr. FRANK OF MASSACHUSETTS. I appreciate that.

The last point I want to make, with regard to health care—and I realize you don't want to get into the specifics of what to do—I was struck on page 12 by a statement of yours which seems to argue for some kind of changes in health care. It was your statement that Congress should avoid enacting policies that create impediments to the efficient movement of individuals across regions, industries and occupations.

We are not talking about creating impediments. Many of us are talking about equity which is important but also to economic efficiency. Would I be correct—without getting you into the specifics—that a health care system which ties people to a particular job, which makes people feel they would pay a price if they changed jobs, in fact would be one of these impediments to the efficient movement of individuals across regions, industries and occupations?

Mr. GREENSPAN. Yes.

Mr. FRANK OF MASSACHUSETTS. Thank you, Mr. Chairman.

Chairman SABO. My apologies for having to leave.

Mr. McMillan?

Mr. MCMILLAN. Thank you, Mr. Chairman.

Thank you, Mr. Greenspan, for your interesting testimony.

It seems to me that, at least in the short-term, we are at a rather interesting intersection with the economy, as you have described it, in a strong recovery, rates generally down, at least short-term, and a historical perspective.

The unemployment rate—I am not sure that you defined what you consider to be the natural unemployment rate. If you care to comment on that, how we stand relative to that? Is inflation under control and potentially under control with policies that you are pursuing?

Yet there are reports in the paper today or yesterday about the possibility that the deficit may be less than the $254 billion projected. I even saw one newspaper account that suggested that if the deficit turned out to be as low as CBO projected today that that might have a negative effect on the economy. I just thought it was rather peculiar. You might want to comment on that.

Yet we have some other things that are potential clouds on the near horizon. The trade deficit figures are not at all encouraging in the last two days. Some consider the weakening dollar to have a potentially significant impact on interest rates.

What I would ask you to do, if you would care to, is to comment on each of these with respect to your long-term objective of bringing down long-term rates and your short-term objective of controlling inflation in order to facilitate that long-term policy.

Mr. GREENSPAN. Congressman, let me just say that last year I argued that because the level of inflation expectations were still sufficiently high that we had long-term interest rates higher than need be; that a perceived credible reduction in the budget deficit, which was perceived to be longer term and not just transitory, would reduce inflation premiums and bring down those long-term rates, and effectively offset the so-called fiscal drag that occurs when budget deficits are reduced; and that the overall impact of budget deficit reduction would be positive, not negative, to the economy.

I would submit that that is still the case, that we still have inflation premiums embodied in long-term interest rates which would respond in a very positive way to further declines in the deficit over the longer term, and that that, in my judgment, would contribute to maintenance of sustainable economic growth.

Mr. MCMILLAN. But the notion that the deficit is going to be less by perhaps as much as $50 billion I think from original projections this year—$30 billion I think would be more correct—isn't in and of itself going to be a negative effect on the economy?

Mr. GREENSPAN. I think not.

Mr. MCMILLAN. In fact, the opposite might be true?

Mr. GREENSPAN. The greater the downward revision is, in my judgment, the better it is for the country.

Mr. MCMILLAN. A couple of specific questions.

How would you quantify the inflationary component in long-term rates today? Would you care to be precise about that?

Mr. GREENSPAN. We have a lot of different estimates. It is a very difficult issue to come to grips with because it is a projection of what we expect the average inflation expectations are of those who deal in long-term market instruments.

One of the reasons I argued in testimony earlier this year for indexed bonds issued by the Treasury is that it would assist us in having a far better judgment as to what the real long-term interest rates were, what inflation expectations and inflation premiums were, and would facilitate a number of things, not the least of which would be monetary policy.

I think there are good reasons to index bonds for other than monetary policy reasons, but I would say to you that the issue comes up most immediately, so far as we at the central bank are concerned, because we cannot effectively answer the question that you asked in a manner which we feel very comfortable with.

Mr. MCMILLAN. The point I think that you have made very clearly, however, is that if through spending restraint, more than spending restraint, we bring the deficit down, we not only have a positive impact on the economy in terms of freed-up savings but we have

a positive impact in terms of inflationary expectations and long-term rates so that we get a double benefit from that.

I am one of several on this committee who have been appointed to serve on the Entitlement Review Commission. And, as you know, the President has suggested that—and it is truly bipartisan in nature—come forth with recommendations by the month of December which, hopefully, would be incorporated in the next year's budget, which I would suggest is going to be the first real opportunity at this late stage to address a number of the questions that are being raised here today, not the least of which is the fact that entitlement growth in the Federal budget is the principal driver of the deficit.

Just to get that in some kind of perspective—and I know the issue of health care is interrelated with those of other issues, with respect to the farm program, social security, Federal pensions and so forth—but if we could achieve what the President himself has stated as a goal of health care reform, although his plan doesn't support it, and that is limiting the rate of entitlement growth to the rate of inflation plus the demographics affecting it, if we could be so bold as to do that, do you think this would have an adverse effect on the economy or a positive effect?

Mr. GREENSPAN. If one looks at the current services budget through the years 1998 and beyond, it is clear that the health segment of expenditures in that period through the turn of the century is the major area where the excess of spending over the tax base occurs. So that, arithmetically, either the upward drift of health care should be addressed specifically or offsetting reductions made elsewhere in the broad structure of Federal programs.

Mr. MCMILLAN. Has my time expired, Mr. Chairman?

I thank the Chair.

Chairman SABO. A couple of quick questions before I yield to Mr. Orton.

In your judgment, are long-term interest rates too high for the realities of our economy today?

Mr. GREENSPAN. I am sorry, the realities of what?

Chairman SABO. Of our economy today? There is a bias, inflationary bias, you say reflected in those rates.

Mr. GREENSPAN. Yes.

Chairman SABO. I would expect if there was not that bias they should, in fact, be lower?

Mr. GREENSPAN. Absolutely, Mr. Chairman.

In the context of the long-term outlook, the inflation premium is too high, nominal long-term rates for the long run are higher than they should be, and if we can credibly hold inflation increasingly toward a path of stable prices, I think with time we will find that that inflation premium will fall significantly.

And that will be much to the benefit of the economy because it will reflect not only a reduction in inflation premiums but also, as part of that process, real interest rates in the long end of the market will also decline since one must presume that inflation instabilities create a higher real rate than would otherwise be the case; and it is the real rate which is crucial to long-term economic growth.

So in general answer to your question, yes, long-term rates for the long-term viability of the economy I think are too high.

We do, however, have to recognize that when you have a strong economy that the tendency for real rates to rise is fairly universal, and that one's judgment about the specifics of real long-term rates and the immediate outlook of the economy really rests on balancing how one views the underlying forward movement up of an economy because you cannot really make a judgment as to the level of interest rates without the judgment of the underlying moment up of the economy.

Chairman SABO. I understood the theory, at least, of the Federal Reserve's position earlier this year in raising short-term rates. The theory was that would have the impact of possibly lowering long-term rates. But the opposite occurred. As I recall, long-term rates went up higher than the increase in short-term rates.

Mr. GREENSPAN. We had expected, as I indicated in my prepared remarks, that the economy's growth would be coming off the high levels of growth at the end of 1993 not at a pace which was somewhat faster than was perceived to have been occurring in the period from mid-February forward.

As a consequence of that and as a consequence of the better expectations in Europe and the Far East of the economy evolving, long-term interest rates around the world went up far more than we had anticipated. But that, in our judgment, is in the context of a much stronger growth in economic activity than appeared to be emerging at the time when we initially moved on February 4.

Chairman SABO. Mr. Kasich?

Mr. KASICH. Mr. Chairman, the point, though, I think that needs to be made in regard to long-term rates, short-term rates are your—as you point out in your—well, they point out in this book that has been written how difficult it is to know when to move interest rates. You are quoted as saying in this book, long-term rates are not a matter of theory. Long-term rates are a matter of people making investments and anticipating where they think the economy is going to go.

Long-term rates have risen because of people's lack of confidence in stable prices and a decent return on the investments they make at a point in time today as opposed to the future. I mean, if long-term rates are not a function of any artificial determination like to some degree yours is, long-term rates are people betting on their investments for the future, correct?

Mr. GREENSPAN. There are two elements involved. As best we can judge, the rise in long-term rates has been partially an expectation of the increased inflation and partly an expectation of real rate increases.

The problem we have, as I indicated before, of separating the two is the fact we do not have adequate data. But what rough indications we do have on the basis of forecasts of people's long-term inflation expectations is it appears it is part of both. But what is, in fact, the case is that if you get a significant increase in the demand for capital in the world, real interest rates will tend to rise if saving are not forthcoming to offset that.

So one has to be aware of—in evaluating long-term markets—the balance of saving and investment. But one can clearly get a rise

in long-term rates, which is not a reflection of a lack of confidence but merely an indication that the investment outlook is particularly propitious and, hence, the demand for funds rises relative to the amount of saving available in the world.

Chairman SABO. If I might come back to a discussion you and Mr. McMillan had in relationship to health care—I think you are both right. When one looks at the Federal budget, that is where the real growth is, much faster escalation of costs and change in the Nation's economy.

When you talk about long-term deficit reduction, I am curious what kind of time frame you have in mind? Quite often when we consider things long-term is a year; when we pass a budget resolution, it is 5 years. It strikes me that that is central to part of the debate on health care that we have right now.

Without getting into how, who, everything of it, at the heart of, at least, the President's proposal—and if his proposal doesn't get there, modifications by Congress would have to get it there—is the assumption you move to universal coverage for a variety of reasons, both equity and stability or flexibility in the labor force. The assumption is that you use savings to get to universal coverage and that you then have a downward impact on total health care costs in the longer period of time.

An alternative would simply be to put price restraints or some type of restraint on growth of existing programs rather than not dealing with it in a more comprehensive fashion. One might produce more savings in a 5-year period; the other might produce more savings in a long-term period.

When we talk about long-term, are we talking about how—the impact a major policy change like health care—and I think that that is the biggest issue this Congress has ever dealt with in its history—are we looking at 5-year time frames? Are we looking at the credibility of what happens with that program in 10 years? Fifteen years?

Mr. GREENSPAN. It is really 5 years out and beyond. We are dealing with an issue in which what is important, in my judgment, for the Congress to do is to alter the structure of law currently in a manner which is credible to the markets that that path will change over the years. And when you are dealing with very big programs or very big aspects of the Federal budget, it is like the proverbial aircraft carrier trying to turn around very quickly. You cannot turn it around quickly. You have to focus on changes which will take years to implement.

Mr. Stenholm raises the very interesting question of the effect of the employment of the Consumer Price Index for various different program escalations in the budget.

When you begin to look at where the levels of credibility are with respect to controlling expenditures, when you get, for example, an entitlement program which essentially is a mix of various different aspects of expenditure escalated by the Consumer Price Index, you obviously know with a very high degree of certainty that if inflation comes down or, more mechanically, the index which you were using comes down, that is a very credible adjustment to the long-term outlook.

If, on the contrary, you have a general view that you will make adjustments under certain criteria over the longer run, that will have less of a sense of certainty to those who are viewing the outlook and the credibility of the Federal budget.

It is very important that we not only change the slope of the long-term spending in this budget but we do it in a credible manner, not in a wish list or in a manner which is readily overturned by future congresses.

Were that to be the case, in my judgment, we would find that a good deal of the remaining inflation bias which exists still in this economy, which I commented on in my prepared remarks, would be excised.

Chairman SABO. I might indicate to you, Dr. Greenspan, and to the committee that the Labor-HEW bill, which was passed out of appropriations a short time ago, does include, at the urging of this committee, additional resources for the Department of Labor so that they have the resources to study and recalculate the CPI.

Mr. Orton?

Mr. ORTON. Thank you, Mr. Chairman.

Thank you, Dr. Greenspan, for your testimony.

In college I enjoyed my economics classes very much. I always was surprised at the grade I received because I didn't really know whether I understood the term or not until I received a grade at the end. Sometimes it indicated I did understand it; other times, it indicated I didn't. As I——

Chairman SABO. Mr. Orton, that was according to the professor.

Mr. ORTON. Yes. That was according to the professor.

Now I find myself in a similar situation. Sometimes I think I understand the economic theories we are working under. Sometimes I think I am in a fog with everybody else.

The Fed has recently been criticized for the efforts that you have made in raising interest rates. They are being criticized. And I will raise the issue of the value of the dollar against the yen. I know that you indicated you didn't want to discuss that in specific but in general terms.

It is really very confusing to the people out there. We are told that the value of the dollar is too high against the yen because we have this huge trade surplus. And if we would push the value of the dollar low against the yen, then that would affect our trade surplus and put more people to work here and generate more income, and that would stimulate our economy. And so a low dollar would be very good.

But then, when the dollar goes low, we are told that that is very bad because that is going to create an inflation pressure in America and force interest rates to go up in order to compete with the interest rates around the world to attract foreign investment back into the dollar, and so we need to push the dollar back up. The suggestion is that by raising interest rates here we may push that dollar back up.

The concern I have and the issue that has been raised in several of the editorial pages of late is that perhaps there is fairly little impact that Federal intervention really can have in light of the broad, broad variety of pressures, domestic and foreign, which are setting

the flows of capital, setting the exchange rates, setting the levels of investment.

A fellow from Oregon is quoted in the paper this morning: "The markets have rendered a fairly typical verdict that intervention in policy coordination mattered very little."

I guess the question I have is, in plain English, just how much control or how much effect can the central bank have in inflation, in trade surpluses, in value of the currency by changing the interest rates? I guess that that is the very basic question—and if, in plain English, you can tell us and the folks at home whether this really has an impact or whether it creates a great deal of pain and not a lot of effect?

Mr. GREENSPAN. I suspect, Mr. Orton, you got more As than Bs.

I wish we were in a seminar in which I could respond to the very interesting questions that you raise. I am not in a position to get involved with that because I know of no way to discuss that without going over the line on what I think is appropriate for anybody to be discussing on this question.

Mr. ORTON. Let me back up and ask a more basic policy question then on taxes.

I am a tax attorney by background and have had a great deal of interest in our policy. I tend to agree with you that the solution is not raising rates, that you cannot solve the problem by extracting more and more revenue out of an economy. The way you have to do it is get the economy growing. The revenue side will rise and increase with the growing economy.

I am known as one of the hawks around here in trying to bring down the deficit. I guess a basic question I would have for you is with regard to tax policy. Rather—is it not true that tax policy can, in fact, have a significant impact—take aside—away the issue of raising or lowering rates but not the amount of revenue we pull out of the economy but the way we pull that revenue out of the economy has a very significant impact, does it not?

For instance, if the way we pull revenue out is by taxing income, by taxing profits, by taxing growth, as opposed to taxing the consumption. And if our system of taxation is fully contained inside the U.S. rather than being border-adjustable as goods and services move between nations, when our other trading partners have border-adjustable taxes which they can take off of their exports and put on our imports.

Does that not have a very significant impact on the formation of capital, on the growth of the economy, on the rate of the inflation, on trade surpluses, deficits, et cetera? Does not the way we extract revenue out of the economy have a definite impact?

And do you have any comment upon some of the suggestions such as that of Chairman Gibbons with regard to some sort of transfer tax or value-added tax? Some sort of tax that is a tax on consumption in place? Not in addition to but in place of taxing capital and growth? And do you believe that that would have an impact on the rate of interest and inflation, et cetera?

Chairman SABO. Excuse me. It is a long question, but just so members know. Dr. Greenspan has to leave about 12. So you should probably not give the length of answer that question deserves. Then, as we move on, to the degree members can keep

questions short, and answers—maybe doing less than 5 minutes—we can maximize the number of people who get to ask questions.

If there is no objection by you, Dr. Greenspan, if members have written questions they might submit, we would appreciate it.

Mr. FRANK OF MASSACHUSETTS. If you ask questions he won't answer, that will speed things up.

Mr. GREENSPAN. Mr. Orton, I agree with your fundamental approach. As a private economist, before I got to the central bank, I took very much the same point of view you expressed. Most economists do because we are looking at the issue of incentives in the structure, and it is a very difficult public policy question. But I found your remarks something which I tend to be generally associated with.

Chairman SABO. Mr. Shays?

Mr. SHAYS. Thank you, Dr. Greenspan, for coming here today.

Dr. Greenspan, when we look at the trade figures, we look at what has happened in the stock market the last week, we look at the value of the dollar to the yen, I am confused with how Germany is having interest rates go up like our interest rates are going up and has strong currency, and we have weak currency. What is the reason for that?

Mr. GREENSPAN. The surprise in the markets which was that earlier this year, when it looked as though the German economy was still moving at a very sluggish pace—indeed all of Europe—was that when our long-term interest rates went up, so did theirs. It was something of a puzzlement to a number of analysts.

In retrospect, what appears to have occurred is that the general massive change in the degree of uncertainty in the markets obliterated the various subtle risk premium differences that exist between currencies. And there was generally a massive endeavor to move from long-term maturities, whether they be denominated in deutsche marks, dollars or yen, back into shorter-term instruments, the effect of which was to bring bond prices down across the board, irrespective of the currency, and long-term interest rates up.

That is a phenomenon which we had not seen for a while and probably reflects, to a large extent, the globalization of our financial systems which has increased in the last 10 or 15 years.

Mr. SHAYS. Given that, it seems to me your tasks become extraordinarily difficult in terms of trying to guide our economy, given this incredible interaction that we have throughout the rest of the world. What is guiding your decisions regarding the Federal funds rate?

Mr. GREENSPAN. It is difficult to answer that without a very long answer.

Mr. SHAYS. Okay.

Mr. GREENSPAN. Let me briefly say to you that what we try to do is to understand what the credit and market conditions are in the economy and how——

Mr. SHAYS. May I relate it to this question then? You are trying to maintain a neutral position. With regard to the Federal funds rate. Maybe you could just explain to me what you really mean when you are saying that.

Mr. GREENSPAN. Well, the concept of neutrality is a very elusive one. We raised it in the context of the latter part of 1993, when

it was fairly clear by what was occurring in the economy that monetary policy was very clearly accommodative and indeed more than was sustainable over the longer run.

So, in that context, we fixed a point where we said that we will be neutral—neutrality being a state in which you are neither adding or subtracting to the degree of stimulus in the system.

There is also clearly a concept in which interest rates and credit restriction can be excessively high. So that somewhere between where we were and extraordinary tightness is a level which, by definition, is—for want of a better term—neutral.

We do not have a specific number. We have a range. And various different members of the FOMC would, I suspect, have slightly different ranges.

The thrust of our argument late last year was that, wherever one ultimately put the question of neutrality, we were clearly well below it and needed to significantly reduce the level of accommodation which we succeeded in doing by any sets of measures by our actions on May 17 when we raised the discount rate and the Federal funds rate by 50 basis points.

Mr. SHAYS. I will just make a comment that maybe you can respond to.

I feel like I am in never-never land when I look at a Federal budget deficit that is extraordinarily high, that will lead to an increase in the national debt of $1.6 trillion in the next 5 years. It is the second highest increase in the Federal debt in any 5-year period.

You seem relatively unconcerned about that. Yet I think, outside here, it explains why long-term interest rates are pretty high. People outside are concerned about that $1.6 trillion increase in the national debt over the next 5 years.

I guess what I am having a hard time doing is reconciling your sense that this is okay.

Mr. GREENSPAN. I don't think I communicated that I thought it was okay, Congressman. I think that the size of the budget deficit is excessive, that it is creating an increase in the level of Federal debt which, in my judgment, is excessive.

The concern that I am raising is the fact that if we don't stabilize the deficit itself—even if we were to do that, we still get a significant increase in the debt. But if we don't stabilize the deficit, it will start to expand, and the problem of the increase in the Federal debt as a percent of the gross domestic product will accelerate.

So I am not saying that I find that I am comfortable with this increase in debt. I would much prefer to see a balanced budget in which, by definition, the debt at that point stabilizes. One step at a time.

Mr. SHAYS. Does it concern you that even this $1.6 trillion increase in the national debt is determined by, basically, our expectation that interest rates will be low for the next 5 years, and we are funding our national debt on short-term debt, and that inflation will be low? I mean, are you concerned that both—that—will you be able to maintain this debt at this $1.6 trillion increase?

Mr. GREENSPAN. All forecasts of Federal budgets require some judgment as to how one views the economy, because, obviously, it affects both the receipts and expenditures.

Cutting through that, when you look at the basic underlying structure of the budget process, it becomes clear that, virtually independently of what the forecasts of the economy, inflation or anything else are, that we do have a situation currently where the rate of growth in expenditures will almost surely exceed the rise in the tax base independently of these other considerations. And that is unacceptable as far as fiscal policy is concerned. That, in my judgment, must be addressed.

Beyond that, you are raising the important question, in my judgment, of should we not go further. And I would certainly say that to the extent that we can is to the extent that it would be beneficial to our economy.

Chairman SABO. Mr. Pomeroy?

Mr. POMEROY. Dr. Greenspan, did the congressional enactment of the budget plan last year play a positive role in inducing the economic recovery presently under way in this country?

Mr. GREENSPAN. You mean positive role in improving——

Mr. POMEROY. Did congressional enactment of the budget have a positive relationship with the economic recovery presently under way?

Mr. GREENSPAN. Yes, Mr. Pomeroy, I think it did, especially the enactment of the caps which—somewhat to my surprise—seems to be working reasonably well, whereas one could have taken a relatively cynical view a while back that that was just fun and games. But it is crucial that procedures of that nature be hardened and enhanced to control the budget process.

In that regard, the expectation that expenditure growth could be contained because the evidence is being suggested that maybe the system can work, and that had a positive effect on long-term interest rates and, thereby, on the economic outlook and economic activity of the last year.

Mr. POMEROY. We have spoken about increasing entitlement expenditures in this country, mostly due to the Medicare and Medicaid programs. Health care reform that does not have as a central point cost containment would really miss the goal from a fiscal policy standpoint, correct?

Mr. GREENSPAN. Well, I don't want to get involved in the specific elements of the programs because it gets to the definitional questions. And then—if you don't mind, I would just as soon pass on that.

Mr. POMEROY. All right. Thought I would throw you a soft ball on that one.

Mr. GREENSPAN. Sometimes one strikes out on the slow sliders.

Mr. POMEROY. The peremptory triggering of interest rate hikes involves enormous costs for the people of this country.

In the State I represent, North Dakota, you see unemployment continue to linger at higher rates than might otherwise have been the case. Farmers are involved in a very capital-intensive business, will be forced to pay much higher costs for their business operations. Small business will be stifled. So it has to be that there are some serious downsides peremptory triggering of higher interest rates.

Your own testimony talks about unemployment probably lingering at above the natural levels. And, given the millions that con-

tinue to be unemployed, I would hope that we would agree that this is unacceptable—7.9 million unemployed presently.

There is, as your testimony notes, capacity for growth of employment within the labor pool. There is additional capacity available in the productive, the manufacturing capacity of this country. All of that would suggest that we have been very anticipatory in dealing with inflation by rising interest rates while we still have with us a very real unemployment problem. How would you defend the Fed's actions in that light?

Mr. GREENSPAN. Our judgment, which, obviously is based on analysis which encompasses a number of the issues raised, Mr. Pomeroy, is that we have to focus on how we sustain economic growth in a manner which is not subject to ups and downs and jolts which are clearly detrimental to the society.

In our judgment, had we maintained the low level of short-term rates which we very deliberately created as a policy starting in 1989, we would have engendered a degree of inflationary instability which would have been destructive of jobs, not creative of jobs. And while it is a very difficult call, because the data are not unequivocal, looking into the future is clearly always somewhat obscure, but we make the best judgment that we can.

In retrospect, I see nothing in any of the data that we have looked at which suggest that we should have not have moved when we did.

Mr. POMEROY. The uncertainty of additional future interest rate increases causes yet a further tremendous stifling effect on economic growth. The market response to the last adjustment seemed to reflect that you are going to hold for a while. I would certainly hope that that is the case.

You note on page 12 of your testimony that monetary policy geared to the pursuit of price stability over time is the central bank's most significant contribution to achieving a maximum goal for a Nation's well-being. I would hope that the fluctuation presently occurring in exchange rates between the major currencies would not be a new element that the Fed would think would warrant interest rate tampering.

Mr. GREENSPAN. I cannot comment on what our future policies would be other than to say what I usually say which is that we are continuously examining all aspects of the forces in the economy. And when we get to a point where the Federal Open Market Committee decides we have to tighten or loosen, we do it.

Fortunately, we do not have these very long lead times that occur in fiscal policy. We have the capability of responding reasonably quickly to forces in the market and in the economy that we judge to be such that monetary adjustments are appropriate.

Mr. POMEROY. No further questions. Thank you, Dr. Greenspan.

Chairman SABO. I have several folks left. Mr. Cox is next. Then Mr. Wise. To the degree the two of you can use less than 5 minutes, we might get someone else in. I will put the pressure on you.

Mr. COX. Thank you, Mr. Chairman.

Thank you, Mr. Chairman. Lot of Chairmen here.

It should come as no surprise that there is always a great deal of press when you testify—because, after all, the Fed's responsibility for monetary policy gives you direct influence on inflation and

interest rates and, hence, in the same fashion, a direct influence on the value of the money in everybody's wallet.

Fed watching is more than a cottage industry. It is a major enterprise throughout the world. We are sometimes reduced to using, even in Congress, unusual sources.

I wish we had more professional services to aid us in this, but many of us, if not all of us on the committee, have recently read this book by Bob Woodward, The Agenda. This is the same author who gave us The Brethren and a look into another secretive institution in Washington, the Supreme Court.

I would like to give you a chance to respond to what we have read in the book about the way the Fed has operated in connection with recent interest rate hikes, and in connection with the development of the Clinton economic plan.

According to the book, the Fed worked very closely with the Clinton administration in the development of their budget package. In fact, Mr. Chairman, you are described at page 135 as a "ghostwriter" of the Clinton plan. Mr. Clinton is described as having characterized the plan that you helped ghostwrite as a "turkey." I know you have read this sort of thing.

At page 144 of the book, Woodward points out that none of the Senators knew that you recommended the deficit target of $140 billion in the Clinton plan. And Woodward attributes to you the view that, quoting Woodward, "It was best that no one knew the extent to which the Clinton financial market strategy was also Greenspan's."

On page 320 of the book, he details an extraordinary meeting between you, the President, Al Gore, Treasury Secretary Bentsen, and Bob Rubin, in which you discuss 2 weeks in advance raising short-term interest rates. Two weeks later, those interest rate hikes followed. We are told that in that meeting, not only Treasury Secretary Bentsen, but Bob Rubin, head of the National Economic Council, recommended that you raise those interest rates.

To the extent that the Woodward book is accurate—and, thus far, no administration official has denied its accuracy—it would appear that, far from being a foil to the Clinton Administration, Fed policy has become an integral part of the Clinton program.

Larry Kudlow, in today's Wall Street Journal, says that far from the Clinton plan comprising "putting people first," it was in fact "putting the bond markets first."

I would just like to ask you, in light of Woodward's book and also in light of the efforts of some of the Clinton administration media spinners to make the Fed the scapegoat for foiling the Clinton economic plans, whether or not we ought to be concerned about these reports: whether they are accurate, and whether the long-term institutional relationship between the Fed and the executive branch has, in fact, been compromised.

The Wall Street Journal piece I mentioned today by Mr. Kudlow, in fact, attributes the rising inflation fears, the 20 percent hike in gold prices since March 1993, the surge in oil prices, the dollar approaching a hundred yen—all to a perceived lack of Fed independence from the Clinton Administration, given that these book excerpts have been printed on page 1 of the Washington Post.

In the interests of setting the record straight, I thought I would ask you to comment.

Mr. GREENSPAN. Let me say Larry Kudlow is a good, old friend of mine. More often than not, I agree with him. I did not agree with his comments in this morning's paper. I don't know what to make of this.

First, we are perceived to be under the thumb of the executive branch. Then we are running the executive branch. I think that this is very unproductive as a view.

What actually happened and what should happen is that there should be a coordinated policy between the central bank and the executive branch because there is one economy and there is one government.

There is, nonetheless, a very crucial issue which is that the Federal Reserve has to be independent in its actions and as an institution because if the Federal Reserve independence is in any way compromised it undercuts our capability of protecting the value of the currency in a society.

I have been very crucially aware of this whole question, and I will say to you that I know of nothing which has undercut the independence of the Federal Reserve, and I see nothing which, in my judgment, will do the same.

I think, however, that it is important that we coordinate with the Secretary of the Treasury—and, indeed, I meet with him quite often—and we explain and exchange policies because they affect each other. And, unless we coordinate, you often have the American economic policy structure going in opposite directions.

So it is crucially important to distinguish Federal Reserve independence, which is a necessary condition for a sound economic policy in this country, and the necessity for coordination. It is an art form. It is not a science.

One cannot write a set of rules which very rigidly determine who does what and in what manner, but I am very well satisfied with the way it has worked out between myself and the Secretary of the Treasury. We very assiduously look towards the notion that our coordination in no way undercuts the independence of the Federal Reserve which he himself very strongly supports.

Mr. COX. Well, I appreciate that response.

I think the Chairman is anxious to give another member the opportunity to ask questions.

Thank you, Dr. Greenspan.

Chairman SABO. Mr. Wise?

Mr. WISE. Mr. Chairman, I feel unprepared for this. I was not able to stop by Crown Books this weekend and catch up on the latest literature to see how you are involved.

The question I have is, is there an acceptable rate of growth and is there a rate which you—is there some benchmark at which you automatically trigger certain changes?

Some say 2.5 percent is sustainable. But at the same time, above that, you have to worry about inflation. Others worry that anything less than 3 to 3.5 percent—that, obviously, becomes important in the whole issue of what is growth and what is it that can be growth without triggering inflation.

My one editorial comment I would make is that any of us who are over 30—perhaps 35—obviously remember—have a searing memory of inflation in the late 1970's. Yet, I want to be sure at the same time we do not overreact to that in formulating policies, at least at this end of the street, overreact to that as we try to put this country on a solid growth pattern.

Mr. GREENSPAN. I am very uncomfortable about the concept of some fixed, rigid level of growth which we cannot exceed without undoing the structure of the system.

There is a very considerable degree of flexibility in the system. It rests very significantly on the degree of underlying productivity growth in society. We cannot control very much the labor input into the economy because people in the labor force are fairly easy to project—you can do it for 5, 10 years out—because demographic capabilities are pretty good. We can forecast what is going to happen there.

We cannot, however, forecast with the same degree of accuracy what the growth in productivity is over the longer run. That really means we do not know precisely where these limits of potential are. The reason we get differences of views is that, effectively, we are looking at different views of what the underlying productivity growth of the economy is, which one really is not able to fully understand except in retrospect, looking at data for years past.

So we have to recognize that there is a degree of indeterminacy here. And it is important for us to be looking at the process of growth and at the elements which tend to create inflation without getting ourselves locked into certain statistical measures which often tend to obscure a process which is very important for us to understand if we are to implement appropriate monetary policy which contains inflation.

Mr. WISE. Following up on that, Dr. Greenspan, particularly dealing with productivity, are there not perhaps newer factors to deal with today that may not have existed back in the 1970's, particularly increased—sustainable—increased productivity, increased competition from manufacturers abroad?

The companies today—United States companies are not able to pass rate increases along perhaps as they were then because of increased competition, greater productivity, greater downward pressure on wages. I would assume, as well, simply the fact that capitalism has expanded abroad. So you have many more free markets.

That—all of these new factors that go into your thinking and the Federal Reserve thinking when you make these decisions?

Mr. GREENSPAN. Indeed they do. We must remember that the economy is always changing. The view of the nature of change that we discuss today we can almost with very few changes have made the same type of speech 15 years ago.

What is terribly important is to recognize you have a major evolving world economy, and what is different is the issue of the extent of the globalization that is clearly taken on very significant effects in the financial system. And it is a complexity which, as you point out, requires that we be very cognizant of all of these various different elements. Because, unless we are, we are not going to be able to effectively understand how our system is functioning.

Mr. WISE. Thank you, Mr. Chairman.

Chairman SABO. We are at 12. Mr. Smith of Michigan and Mr. Inglis have been here since the beginning. If you could, one short question each. My apologies to the others—Mr. Hobson and the other Mr. Smith.

Mr. SMITH OF MICHIGAN. If it is short enough and the answer is short enough, maybe two.

Chairman SABO. No, just one.

Mr. SMITH OF MICHIGAN. May I conclude from your statement, Dr. Greenspan, you feel the market and economy would look favorably on Congress taking another look at reducing spending for next year and the following years?

Mr. GREENSPAN. Yes.

Mr. SMITH OF MICHIGAN. The follow-up—may I do that? That was really quick.

Chairman SABO. Okay.

Mr. SMITH OF MICHIGAN. The follow-up question would be, since so much depends on perception, is it reasonable that your actions for monetary policy only are adequate to the extent that the marketplace reacts in the way you expected?

Your short-term interest rate increase seemed to be perceived by the marketplace as maybe you knew something that they didn't. And so, actually, the demand curve sort of increased, and they didn't respond the way you thought they were going to.

Mr. GREENSPAN. Well, no. I think the response was different from the way we expected because the outlook for the American economy began really to accelerate a week or 2 we made our first move. And that changed the perception of what the structure of the outlook was.

But it is pretty clear that, with the exception of our getting some information ahead of everyone else, we do not have access to information that the public does not have access to.

Chairman SABO. Mr. Inglis?

Mr. INGLIS. I thank the Chair for his kindness in letting us ask a question of the other Chairman.

On page 12 of your testimony, you say something I found very interesting. I don't have any agenda behind this. I am looking to be educated.

You say Congress should avoid enacting policies that create impediments to the efficient movement of individuals across regions, industries and occupations or that unduly discourage the hiring of those seeking work. Can you give some examples of those kind of policies?

Mr. GREENSPAN. Let me tell you in general what the issue really gets down to.

We have an extraordinarily flexible labor market in this country. In fact, when the Europeans were confronted with exceptionally high unemployment, especially long-term unemployment, looked to the United States, they looked with a certain degree of envy that we have the capability of people moving from one segment of the country to another.

Our labor market turnover is very high relative to many other industrialized countries, and it is one of the reasons why we have

got a much higher level of productivity and standard of living than the rest of the world.

The point I am making here, without getting into specifics in that particular comment, is that there are numbers of things which government does which rigidifies labor markets, prevents people from moving back and forth, prevents them from being hired, largely because it is difficult to fire them sometimes. And it is those types of rigidities, those types of inadvertencies, in many respects, which creates a degree of lack of flexibility which we still have in part, which we should endeavor to try to remove.

It is only in that regard that we are able to get the unemployment rate down as low as we possibly can because it is not a macroeconomic, not a monetary policy question. It is not even really so much a direct fiscal policy question. It is sort of a structural question of the flexibility and fluidity of our labor markets.

That is important for productivity. It is important for the economic growth. It is important for the whole society's evolution, in my judgment.

Mr. INGLIS. Thank you, Mr. Chairman.

Chairman SABO. Dr. Greenspan, thank you very much for being here today. I think it has been a very good hearing. We appreciate your coming and your thoughtful testimony. Thank you very much.

Mr. GREENSPAN. Thank you very much, Mr. Chairman.

[Whereupon, at 12:07 p.m., the committee was adjourned.]

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